RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Nov. 8 DJIA 1404.36; PTI 1954; A-D Ratio -13.93
Nov. 15 DJIA 1435.09; PTI 1970; A-D Ratio -13.22

THE MARKET: The stock market is confusing perhaps 90% of the time. Oh sure, there are periods (maybe once every few years) when everything is out in the open -- the averages are all confirming, the sentiment studies are beautiful, the monetary background is perfect and the total picture is clear as a bell. But as I say, 90% of the time it's not a case of perfection, it's a case of confusion.

Some of the confusion was taken out of the market on Nov. 11. On that day the Dow closed at a record high of 1431.88. On the same day my Primary Trend Index (PTI) hit a record high of 1462, and the following indices and averages all recorded new highs: the D-J 65 Stock Average, the NYSE Composite, the NYSE Financial Index, the NYSE Industrial Index, the S&P 500, the S&P 400, the S&P Financial Index. It was a pretty impressive list.

Much is being made of the failure of the D-J Transportation Average to confirm (it would have to go over 702.60 to confirm the Industrials). My only answer here is that (1) we can't have perfection, and (2) we have to give the bull market every benefit of the doubt. True, the Transports have not confirmed, but they have been moving up in the same direction, and the odds are that in due time the carriers will confirm. Yes, we are entitled to be a bit nervous in the face of the Transport non-confirmation, but nervous is one thing and bearish is quite another.

I'm getting a lot of calls now, and I must say that many of the callers are nervous, angry, disgusted and either skeptical or bearish. So I know from first-hand experience that the public still is not with this market advance, and in many cases they are fighting it.

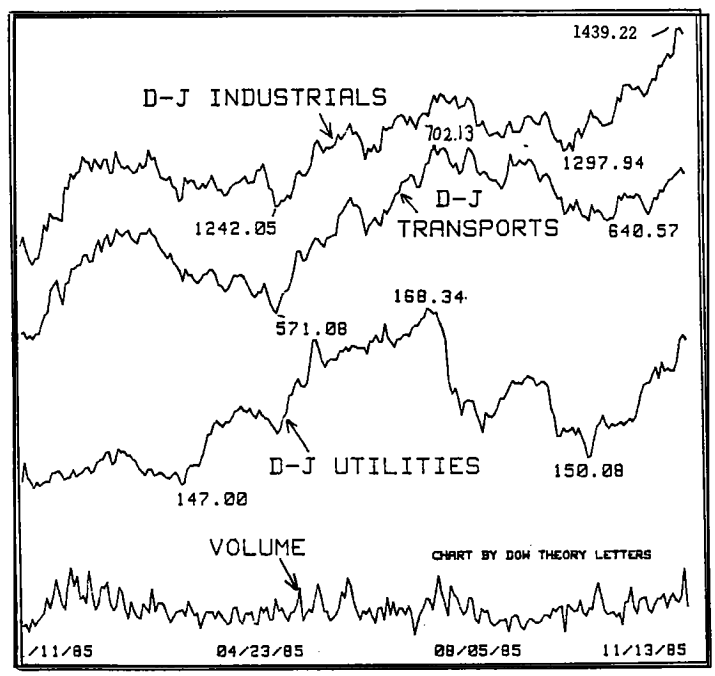
If people would just cease trying to make the stock market jibe with the front page of the Wall Street Journal they would be a lot better off. The work of the stock market is not to get in gear with the Journal, it is to LOOK AHEAD. The function of the stock market (and all markets, for that matter) is to DISCOUNT THE FUTURE. For my newer subscribers, I will repeat that basic thesis -- the Wall Street Journal and Business Week and the New York Times deal with what happened yesterday, the stock market deals with what may happen tomorrow.

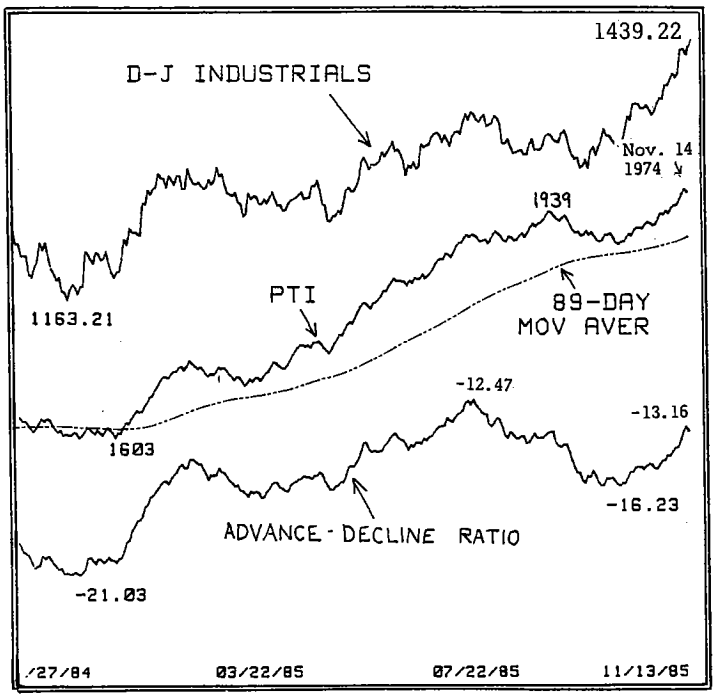
Now I'll admit that I don't know exactly what this stock market sees ahead. And just why the Dow is up over 1400 and down to a yield of 4.5% I don't know. But it's obvious that the market likes what it sees out there. The stock market is happy about something, and it's telling us all about it by remaining in a bull trend. Call it an imperfect trend, complain about the Transports, tell me that the Utilities have not yet hit record highs (which they haven't), but I will point to two items: (1) The Dow Theory remains bullish; we haven't had anything like a bear signal yet, and (2) My PTI, after issuing warnings during October, is recording new bull market highs again. And that's the real story -- anything else can be placed in the category of "bearish dreaming", which I'm afraid is what a lot of people are doing.

It hasn't been an easy bull market for many people. Nor, for that matter, has it been a cinch for many of the pros who run the funds. Right now the majority of no-load funds are doing well, with such funds as Columbia Growth, Fidelity's Magellan, Neuberger Berman's Guardian all doing superbly well, and all of these funds are still at or near their highs. On the other hand, such funds as Fidelity Technology, 44 Wall Street, Hartwell Leverage have been having a rough time of it.

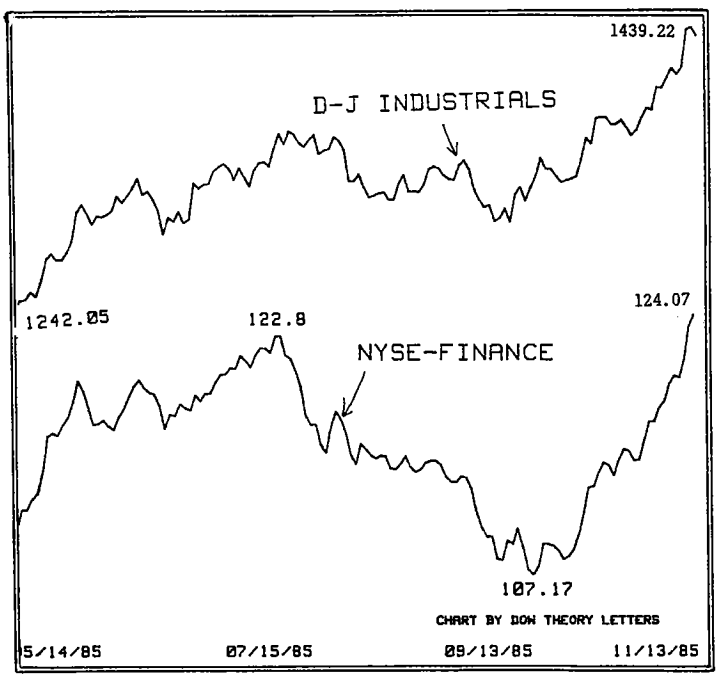
Over the past year I've switched a lot of my allegiance from the no-load funds to the strongest Dow stocks. I did it on the thesis that (1) this is a bull market, (2) in a bull market the Dow almost always leads the way, and (3) the strongest of the 30 Dow stocks will be the surest bets from here on. So far, as subscribers know, that system has worked out pretty well. Mind you, I'm not knocking no-load funds. But everybody suddenly started to recommend them, and consequently I started thinking in terms of the strong Dow stocks such as Westinghouse, Woolworth, Owens-Illinois, General Foods (now part of Phillip Morris) and so forth.

FINANCIAL CONFIDENCE: One of the forces behind the bull market action that we're seeing on Wall Street



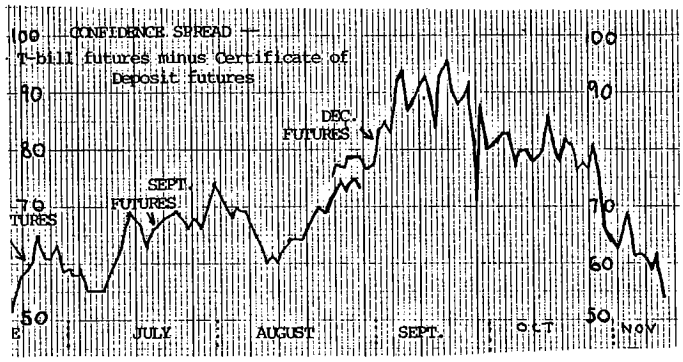


today is financial CONFIDENCE. No, I'm not guessing or talking through my hat. I can back that statement. The accompanying chart traces the recent action of the NYSE Financial Index. This broad index contains all the banks, savings and loans, small loan, insurance



and stock brokerage firms listed on the NYSE. In other words, this Index covers the whole financial spectrum. Last week the financial index broke out to a new high. And that (despite all you hear about bank failures) represents real confidence on the part of Wall Street.

A second excellent index of confidence is the spread between the top-quality T-bills and the lesser-quality (but higher yielding) bank certificates of deposit. The greater the fear, the wider the spread; the greater the confidence, the narrower the spread. Theoretically, if investors had total confidence in the banks which issue the CDs there would be almost no spread differential between the bills and the CDs.



Last September the spread on the futures contracts rose to a nervous 95 points. But since then the spread has been declining, and last week the T-bill futures price minus the CD futures price narrowed to 56 points, smallest spread figures since last June. I rate the spread as follows: 50 to 70 points equals confidence. Over 100 points equals nervousness. Over 200-point spread means real fear. Over 300 points and you're seeing panic.

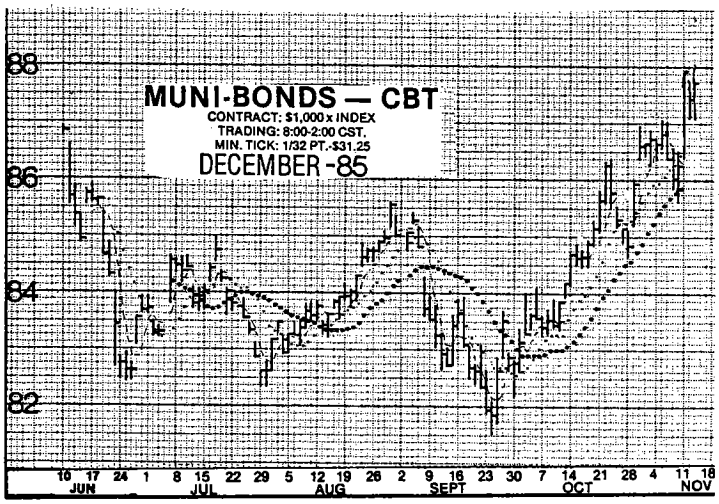
INVESTMENT POSITION: The page 2 chart shows the PTI surging into new record high territory (the upside breakout was discussed in the last Letter). This bull signal in the PTI has been followed by new historic highs in the major composite averages. The bull therefore remains in this box. The stock market has been fired by the incredible strength in the bond market, and it appears that both Treasury and muni bonds are moving into a whole new (lower) yield range. The long T-bonds are now flirting with a break below the 10% yield level, and should this occur it will be a huge plus for the stock market (and of course, for the entire bond market).

Despite Congress's ridiculous and embarrassing stalling, I continue to believe that Congress must come up with a deficit reduction plan to go along with a lifting of the debt ceiling. We should know within a month.

At this point, it would be late to recommend additional stock and bond positions. But for the benefit of new subscribers, I might mention that I like the big city bank stocks, including JP Morgan, Bank of New York, Bankers Trust, Security Pacific, Mellon. Most of these are selling at low multiples of 7 to 9, and most yield around 5%.

BONDS, RATES: I've been writing about the advantages of municipal bonds until I'm sure my subscribers are tired of hearing about them. But evidently someone out there has been listening, because the munis have acted spectacularly over the last few months. This daily chart (courtesy of Commodity Trend Serv., 1-800-331-1069) shows all the muni action since the muni futures contract was first made available last June.

It doesn't take a technical genius to analyze this chart. Since late-September it's been up and up for the munis (along with the T-bonds) and on November 13 a mighty rise of almost two points carried the contract to new highs. This has all occurred in the face of massive muni financing, much of it being issued to beat the restrictions of a possible new Federal tax bill. Tax bill or not, the huge supply of



munis has been swallowed up by the market in what many bond observers have termed a "buying panic".

Subscribers who have heeded my advice and bought high-grade (AA-rated or better) should now have locked in fat, tax-free yields at advantageous prices. If you happen to be in the 50% bracket, tax-free bonds from your state are comparable to taxable yields of 17 to 19%. Try bringing in that kind of return, year after year, in the stock market or in any other market.

People ask me why the bonds are so strong. Well, (1) the inflation rate is very low, and bonds usually yield about 3% above the inflation rate. On that basis, T-bonds should now yield 6-7%. (2) Congress is under pressure to do something about the budget deficits. And they just may do it. Personally, I can't see how they can get away with doing nothing (except raise the deficit ceiling) here in 1985, but Congress's cowardice sems to know no bounds. By the way, part of the cowardice can be seen in the term budget balancing -- rather than spending restrictions. You can balance a budget by raising taxes without cutting spending -- remember?

I'm getting every kind of question about the munis, but I continue to like the general obligation bonds from your own state (unless your state has no taxes, in which case, buy AA or better munis from any state). General obligation bonds from the states are almost all very liquid and your broker can explain the call features of each individual issue. There's nothing wrong with the unit trusts (I particularly like Nuveens) or the no-load muni funds but I still like the state GOs the best. As for insured munis, I prefer to avoid them (if a bond needs insurance, I don't want it. Why? Because then I may have to worry about both the bond and the insurance company.).

PREORDAINED: Man hates the unknown. I have studied hundreds of investment advisory services since the 1940s, and I have seen where there is always the temptation to provide subscribers with certainty. In this business, certainty sells. Certainty may not be right, it may not make sense, it may promise much more than can ever be delivered -- but it SELLS. The fact is that speculating and investing is a scary business and the crux of the fear is the uncertainty of the markets. So one of the selling techniques used in this business is to offer certainty and never to be in doubt. No other technique equals the certainty approach in selling.

The second great selling technique is to promise that you, the subscriber, will get something for nothing. In other words, you may not have paid your dues, you may not even have made a cursory study of the subject, but "buy this service and you're on your way to making money". That's the promise -- "Follow me, and riches are yours." Of course, this is really just another way of offering certainty to a public that is looking for an easy way to make money without the sweat.

In the stock market there are two general technical methods used for forecasting the future. One is that market movements are subject to periodicity or cycles. In other words, every 10 days or every 40 days or every four years the market will do this or that. This is the cyclical approach. The other approach is that the market is subject to certain preordained patterns. This is basically the Elliott approach. Elliott placed greatest emphasis on the pattern of advances or declines rather than their periodicity.

Is there any validity in either the cyclical or the pattern approach to market analysis -- or are both of these simply a way of banishing uncertainty? Frankly, I don't really know. But I will say that the older I get and the more I see of the markets, the more I depend on the MARKET ACTION itself and the less I depend on techniques that attempt to read the future.

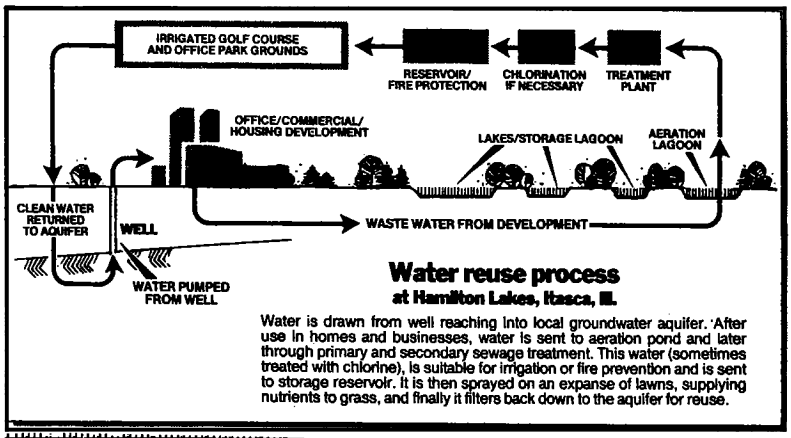
However, there is one set of observations that I agree with, and it is the time-honored Dow Theory observation which states that markets are subject to major and extended SWINGS IN SENTIMENT. At the low of sentiment the public is discouraged, pessimistic and in a black mood regarding investments. The psychology here is one of hopelessness. "Stocks," says the public, "are finished. Wall Street will never recover again." This is the psychology of a major bear market bottom; it is the psychology seen in 1932, 1942, 1949, 1974. Stocks, when such black sentiment prevails, are usually in an area of great values as measured by yields and price/earnings ratios.

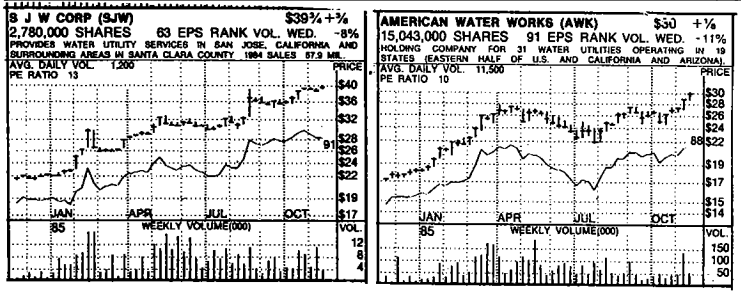
Following such depressed conditions it is almost certain that the market will embark on a long journey to higher levels. The journey (which we call a bull market) may last a few years or a generation. But at some point in the future, we know that public sentiment will be as foolishly optimistic as it was absurdly pessimistic at the bottom.

This, then, is the cycle which I have seen and in which I believe.

WATER: I've been writing about the coming water shortage and recommending water stocks for many months. But one problem in view of the booming US population is -- where is all the water going to come from? I think the wave of the future is in water reprocessing. The page 4 chart from the November 13 Christian Science Monitor (which, by the way, is a great national newspaper and deserves to be read by everyone) shows how three communities are now actually reprocessing their water. The method was developed by Jack Schaeffer, and these systems are now working in Itasca, Ill., Muskegon County, Mich., and North Glenn, Colo.

In other words, water in the reuse system is not just used and then discharged as waste water somewhere else. In the water reuse process the water is used, reprocessed and reused again. As I said before, I believe this is the wave of the future, and I believe it will make water companies that much more attractive.


IRRIGATED GOLF COURSE AND OFFICE PARK GROUNDS
RESERVOIR/ FIRE PROTECTION
CHLORINATION IF NECESSARY
TREATMENT PLANT
OFFICE/COMMERCIAL/ HOUSING DEVELOPMENT
LAKES/STORAGE LAGOON
AERATION LAGOON
CLEAN WATER RETURNED TO AQUIFER
WELL
WASTE WATER FROM DEVELOPMENT
WATER PUMPED FROM WELL
Water reuse process
at Hamilton Lakes, Itasca, Ill.
Water is drawn from well reaching into local groundwater aquifer. After use in homes and businesses, water is sent to aeration pond and later through primary and secondary sewage treatment. This water (sometimes treated with chlorine), is suitable for irrigation or fire prevention and is sent to storage reservoir. It is then sprayed on an expanse of lawns, supplying nutrients to grass, and finally it filters back down to the aquifer for reuse.



(Note: American Water Works hit a new record high of 30 last week.)

The following water stocks are on my recommended list: Amer. Water Works (NYSE), Southwest Water (OTC), Consumers Water (OTC), SJW Water, formerly San Jose Waterworks (AMEX), Calif. Water Service (OTC), Hydraulic Co. (OTC). The daily charts courtesy of Daily Investor (newspaper) shows two of the water companies at new highs last week.

THE ANNUAL YEAR-END RUSSELL FANTASY: The following is hardly preordained. We're now enjoying a bull market, and I have constructed a little fantasy to try to explain what might happen. If you are a chronic bear, just skip this section. I just wrote it to give today's many short sellers something to ponder.

(1) Congress feels intense pressure from its constituents to cut the deficits. In fact, the pressure becomes so great that Congress actually does something about it. Deficits are slashed drastically, leading (hopefully) to zero deficits by 1991.

(2) The bond market, seeing that something is actually being done on the deficit front, takes off with long-term Treasury bond yields dropping below 9%. Long-term high-quality muni bond yields drop into the 6.7% yield area.

(3) Mortgage rates come down dramatically, and a new housing boom is underway. A weaker dollar allows for some progress on the balance-of-payments front. While not great, business picks up across the nation. There is intense competition, but this holds inflation down to almost zero levels. With no inflation and still-high "real" interest rates, bond yields drop even lower.

(4) On the political front it becomes patently clear that Russia wants to cut back on its military, since Gorbachev has promised to double civilian output every 15 years. On top of that, the war in Afghanistan is costing Russia a fortune, and it is being widely termed "Russia's Vietnam". To make matters worse, Soviet oil production has topped out, and Russia is now in dire need of hard currency.

(5) At the same time the pressure is on in the US to reduce the deficits. Fully one-third of all US government spending goes to the military. Pressure to cut military spending therefore becomes intense.

(6) With both sides (for different reasons) desperately wanting to cut back on expenses, an arms treaty entailing initial cutbacks is finally signed. The Russo-American treaty is hailed as an international triumph.

(7) All this catches Wall Street with a primary bull market still in force. Following an initial celebration, the market (now extremely overbought) lapses into a trading range. Neither the wild-eyed bulls nor the hand-wringing bears prove to be right.

(8) Stockholders perceive that an era of stability has crept over the West. Serious investing for income takes over from rampant speculation. Fundamental analysis becomes popular again while technicians take their lumps.

(9) The hard money camp continues to warn of "the great inflation" ahead. But it never happens. World production of goods is simply too massive. China and the satellite communist countries boost their production dramatically, and the US turns more and more to service and technology. Gold, silver and the precious metals follow the stock market's example. They drift into long, extended trading ranges.

The market's trading range extends with stocks and industries within the trading range rising and falling, but with the rises canceling out the falls. Speculators are frustrated, but long-term holders are rewarded. The Dow trades within a 400 point range of 1200 to 1600 for years. Many begin to talk of a "new era of stability" on Wall Street. It's the era of instant communication, sophisticated international investing, but the emphasis is on values and income. The stock market, seeming to defy gravity, looks good even as the US standard of living slowly declines. And then, after an unprecedented period of stability, something happens which no one could have foreseen, the ... .

NOTES & QUOTES: I've written before that one of the chinks in the Soviet armor is the lack of computers and computer know-how. Recently Datamation (a computer report) published an eye-opening translation from a boastful Russian report, a report that runs as follows: "Between 1981 and 1984 ... 2,492 automated control and information processing systems were set up (in Russia). That's more than the whole five years of the previous Five Year Plan (1976-80)." But IBM produces more every month! So far, the best that the Russians can offer is 64-kilobyte memory chips and even these are hard to come by. In the West 1 million-bit chips are available commercially. Datamation believes the Russians are five years behind us in computers. And this may be one reason why the Soviets are so afraid of our "Star Wars" program which will depend heavily on advanced computers.

More Russkies: The current issue of Fortune contains two excellent articles on Russia , one on the new push to bring Russian business management into the 20th century, the other on Russia's horrendous problems with computers and micro-electronics. Both articles are fascinating, and I recommend them.

If you're wondering about the Russian hysteria regarding our Star Wars program, the real story is in the Fortune articles. Among other things, Star Wars will require state-of-the-art micro-electronics plus the most advanced computer software programming. Russia is pitifully far behind the US in both fields. Thus, Russia is frightened of any US move into super-advanced defense systems, systems which would find Russia years behind in terms of technology. Therefore -- expect a continuing barrage of Soviet propaganda all aimed at halting the US Star Wars program. Russia knows that Star Wars research will also lead to many new weapon concepts on the part of the US, and this advanced research (particularly in micro-electronics) is the area where the Soviets are just not prepared.

Question of the year: Many US scientists and experts claim that there is no way that any Star Wars defense system can work. If so, why is Russia so afraid of it?

* *

Words for the Ages Dept: From a book review column ("Belly Up", Crown) by John Train in the Nov. 4 WSJ:

In Oklahoma the whole roller coaster is passing into legend, including the tale of the oil man who at his bankruptcy hearing is asked where all the money had gone. "I spent a third of it on a jet, a Mercedes and Vegas," he answers. "Another third went for women, dope and booze." "Well, what happened to the other third?" asks the examiner. "Oh," answers the oil man, "we just [piddled] that away."

* *

From the "Show Me" people: From a speech by Missouri Senator Eagleston, October 24:

Not so long ago, it was said Missouri was first in shoes, first in booze and last in the American League. Today, we are first in the American League but last in shoes. Only booze seems to be holding its own.

* *

It's a well-known fact that Hollywood and almost every other place have been producing too many films, and the quality of all these movies has been generally low. When this occurs then capitalism has a way of handling the problem. It's called "weeding out". Over the past year the following have gone out of movie production: ABC Motion Pictures, CBS Theatrical Films, Melvin Simon, Lord Lew Grade's AFD, Time-Life Films, General Cinema, American Cinema, Filmways.

* *

Big and Beautiful: Vogue magazine recently took a poll of its fashion conscious readers. The results "astounded" the editors. A full 20% of its 7.5 million readers wear a size 16 or larger, and 49% of its readers were a size 12 or larger. For years Vogue has preached that thin is in. But evidently, the readers don't listen!

* *

Circulation at Barron's and the Wall Street Journal has been sliding. But not so at Gannett. USA Today came out at 25¢ a copy, and I liked the paper immensely. Then USA went to 35¢, and circulation continued to climb -- up to 1.2 million. When USA this year went to 50¢ I said, "That's going to hit circulation." I was wrong, at 50¢ USA Today is now at 1.4 million. They must be doing something right -- and they are! They've put out the jazziest and most unusual paper to emerge in years.

* *

N.O. & NYC: The major portion of this Letter was written after our return (on Nov. 11) from New Orleans and New York. These two are America's only real "street scene" cities, and by that I mean that you get the whole show right there in the streets. At New Orleans I spoke before the National Committee for Monetary Reform and I was also a member of Lou Rukeyser's economics panel. It was a great conference (over 2,000 attendees) with featured speaker Ambassador Jeane Kirkpatrick delivering a stirring address -- in which she stated that the US has got to start backing the right governments. Faye and I later joined Seminar sponsor Jim Blanchard, his wife and Kirkpatrick for a most interesting lunch. (I am fast coming to the opinion that Kirkpatrick would make the ideal Republican Vice President.)

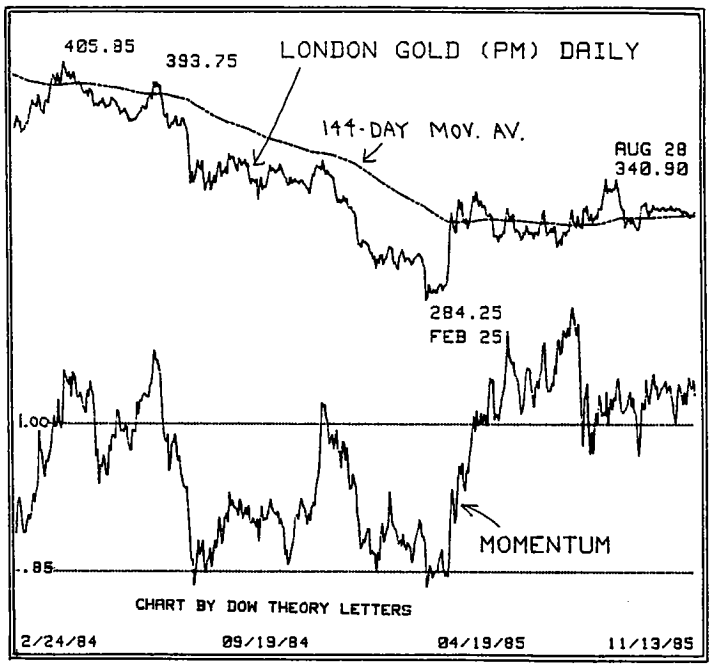
Compared to the filthy sidewalks of a few years ago, New Orleans is now a sparkling clean town (they actually steam-cleaned it for the world's fair). We toured the famous French Quarter with Charlie Maxwell and his wife. Charles is a VP with C.J. Lawrence and is generally conceded to be the top oil analyst in the nation. Maxwell believes (as I do) that the US could be facing a long(maybe 10 years or longer) period of disinflation and debt-reduction. Charlie also feels that oil could go down to roughly the $23 level, and then stabilize.

There's only one restaurant in the US that I'll stand in line for, and that's K-Paul's in New Orleans, owned and overseen by 400-pound chef-genius Paul Prudhomme. We braved the line (for the second time in three years) and had one of Big Paulie's spectacular Cajun dinners, jambalaya along with blackened redfish and a red-hot Cajun martini (made with jalapeno peppers and served by the pint!). If you get within 100 miles of New Orleans, take my advice, get to K-Paul's -- it's an experience you will not forget.

Then on to NYC, where we walked our sneakers down to the nub. We caught the opening of the new Limited on Madison Avenue (the Limited and the Gap are the hottest apparel chains in the country). We had dinner with two of my old high school buddies at Fu's, perhaps the best Chinese restaurant in midtown Manhattan. I might as well reveal it -- my vote for the sleeper restaurant in NYC: Wood's on Madison Avenue -- try it, you'll love it, especially the pasta.

NYC Scenes: "Stretch" limousines everywhere (they're the transportation of choice for Manhattan's power freaks) ... derelicts sleeping nights in Park Avenue doorways or in church crevices, NYC is still the graveyard of missing men ... Macy's is now the City's new "hot store" ... Shops and galleries on Madison Ave. are the most fascinating and creative in the nation (forget Rodeo Drive) ... Everybody complains about the outrageous Manhattan prices -- yet it seems everyone wants to live here (one room studios can run $1,000 and up) ... A martini and a Perrier water cost us $9 plus tip at the bar in the Regency ... NYC is still the nation's showplace, you can see more culture, money, power, merchandise and food in a day in NYC than you can see in a month anywhere else ... But after three or four days in NYC I'm always ready to return to La Jolla. I think I have a love affair with the Pacific Ocean.

Last thought: The ultimate sin for a New Yorker -- buying at retail. If it can be built, conceived, imported or invented, you can get it in NYC. And the odds are it will cost you one-third or half off -- if you look around and ask around.



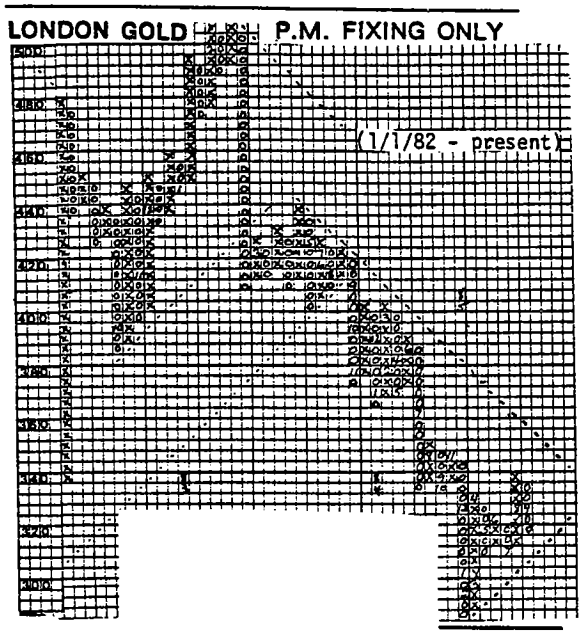
GOLD, BLACK GOLD: What's the surest way of losing money in the markets? Easy, act on what everyone knows and trade on the obvious. Want some examples? Last September crude oil was $26 a barrel on the futures contracts. At that time (remember?) everyone was predicting a massive collapse in the oil price. Since then I've shown chart after chart indicating that oil had based and was moving up strongly. Last week December crude (futures) sold at 31.42, while North sea spot oil was selling for 30.50 a barrel! Yeah, OPEC is falling apart and oil is coming out of everyone's ears. But the price of oil has been climbing and climbing. In fact, oil has been one of the best investments in the commodity spectrum over the past year!

Another obvious case: The US government has been running huge deficits, and in the face of massive and continuing financing, the bond market OBVIOUSLY has to be heading down, right? Sure, except that the bond market has been super-strong for many months.

Let's try a third obvious item. Gold and oil have always tended to move together. So with oil very strong (and the dollar weak as well), gold is a sure-shot to go through the roof along with the other precious metals. Yeah, but that isn't exactly what has happened.

This computer-drawn chart depicts the gold story to date. Gold hit a high of 340.90 last August and it has not been back there since. Technically, gold is now sitting on its 144-day moving average. Gold momentum (89-day rate-of-change) is still holding above 1.00, which means that gold is above its price of 89 days ago. But the fact is that oil, bonds and the stock market have all out-performed gold for month after month.

Let's update the point & figure chart (chart courtesy of Chartcraft, Larchmont, NY). Technically, when gold rose to the 328 box it turned bullish. From here, a rise to 344 for the London fix would be quite bullish, and a further rise above 360 would warrant serious buying in the gold category. But -- it hasn't happened yet. My gold-to-common stocks ratio (gold divided by the NYSE Composite) just hit a five-year low. Normally, this ratio is in a rising mode when gold is a buy. And it certainly is not in a rising mode now.



All this notwithstanding, I am continuing to buy a small (fixed number) of gold coins at the first of every month. Why? I just like 'em, and I'm very stubborn. Last week it was announced that S. Africa has totally ceased minting Krugerrands. That's OK, they'll probably ship out their gold in bullion form instead. And despite US anger and propaganda, I like the Krugerrands, and you can buy all you want here (they just can't be imported). I also like the Austrian Kronas, although neither the Krugies nor the Kronas are popular coins today. The Kronas contain .98 of an ounce of gold and sell for around $322, so you are only paying about $5 over actual gold content for these coins. The very popular Canadian Maple Leafs sell for about $15 over gold content.

LATE NOTES: There are some markets that you just don't argue with. This bull market is one of them. Like it or hate it, it just keeps going up -- and up. The 1985 bull market has also produced the best-advertised non-confirmations and divergences I've ever seen. It almost seems as if the discrepancies were manufactured to keep today's swelling army of technicians out of the market. Wall Street, always a master of pure spitefulness, has now succeeded in advancing the Dow 140 points while keeping leading analysts and technicians in a state of hand-wringing exhaustion. And I guess much the same can be said of the spectacular 1985 bond market. It's the same old story -- the best advances on Wall Street occur when everyone hates or distrusts the market.

One by one the major averages are confirming the Dow on the upside, and my PTI pushes into new high territory day after day. Watch the 702.13 (D-J Transports) and 168.34 (D-J Utilities) levels for additional confirmations. It would be nice to have a picture-perfect market (but now that I think of it, I've only seen three or four of these over the past 40 years).

NEXT MAILING: Dec. 4